

SALT INSIGHT

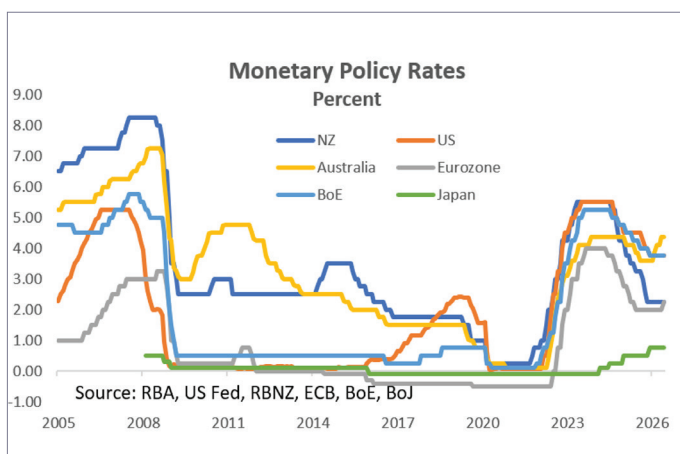
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Central Bank Meetings This Week

As expected, the European Central Bank increased rates by 25bp last week. The rate hike was motivated by increasing inflationary pressures and the need to ensure that inflation expectations remain firmly anchored.

The ECB meeting marks the beginning of the latest round of major central bank meetings, with the Federal Reserve, Bank of Japan, the Bank of England and the Reserve Bank of Australia (major for us in NZ!) all set to announce policy decisions this week.

While each economy faces its own unique challenges, a common theme has emerged. Policymakers are attempting to balance the inflationary implications of higher energy prices against the risk that tighter monetary policy, in many cases, further undermines already fragile economic activity.

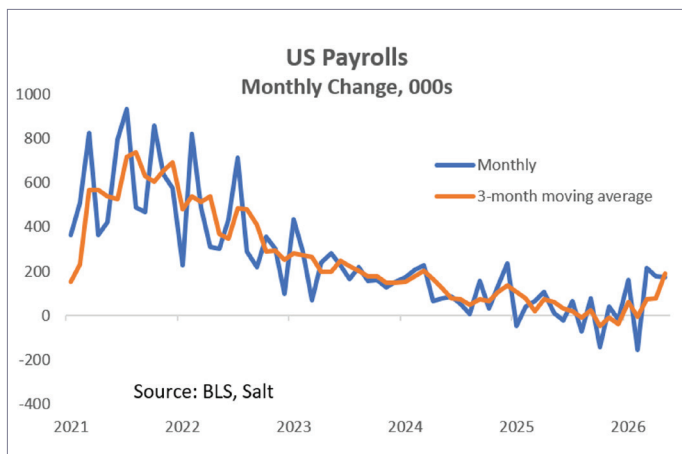


Federal Reserve: the first Warsh meeting

The Federal Reserve is expected to leave rates unchanged this week. While financial markets have moved dramatically over recent weeks, shifting from pricing further rate cuts to now assigning some probability to future rate hikes, the hurdle for an immediate move remains high. The June meeting is therefore less about the policy decision itself and more about communication.

It will also mark the first Federal Reserve meeting chaired by Kevin Warsh. His appointment was widely interpreted as potentially ushering in a more dovish era for US monetary policy, particularly given concerns earlier this year that a weakening labour market would eventually require further policy support.

The challenge for Chair Warsh is that the economic backdrop has changed materially since those expectations were formed. The US economy continues to demonstrate remarkable resilience. Growth has slowed from the exceptionally strong pace seen over recent years but remains positive, while inflation has proven considerably more persistent than many had anticipated. At the same time, the labour market narrative that underpinned recent, and expectations of future, rate cuts has become increasingly difficult to sustain. Payroll growth has recovered, unemployment remains low by historical standards and broader labour market conditions no longer point to a meaningful deterioration in economic activity.



In many respects, Chair Warsh is inheriting a policy debate that has already moved on. Rather than discussing how quickly rates should be cut, markets are increasingly debating whether the next move in rates could ultimately be higher.

That does not mean a rate hike is imminent. Federal Reserve decisions remain the product of a committee and policymakers will want additional evidence that inflation pressures are becoming embedded before tightening policy further. However, this week's meeting provides an opportunity to resolve the tension that emerged at the previous meeting between the statement and the Committee's economic projections. While the forecasts suggested inflation risks had increased and policy rates might eventually need to move higher, the accompanying statement retained language that many interpreted as preserving an easing bias.

The most likely outcome is a statement that acknowledges the increased inflation risks, removes any residual easing bias and reinforces the message that policy will remain restrictive for as long as necessary.

Bank of Japan: another step towards normalisation

The Bank of Japan faces a very different set of circumstances. After decades battling low inflation, Japan is now experiencing inflation comfortably above target alongside stronger wage growth. The case for continuing policy normalisation has therefore strengthened considerably.

We expect the Bank of Japan to increase rates by 25bp this week, representing another measured step away from the ultra-loose settings that characterised the post-GFC and post-pandemic periods.

The meeting is made somewhat more interesting by Governor Ueda's absence (he's in hospital). While that introduces an unusual dynamic, it should not materially alter the outcome. The direction of travel has already

been well signalled and policy decisions are ultimately made by the Board rather than any single individual.

A further rate increase would reinforce the view that Japan remains committed to a gradual normalisation process, even as other central banks grapple with weaker growth and renewed inflation pressures.

Bank of England: the stagflation dilemma

The Bank of England arguably faces the most difficult challenge of any major central bank.

Unlike the Federal Reserve, which continues to benefit from a relatively resilient economy, the UK is confronting a far less favourable combination of weak growth, poor productivity performance and persistent inflation pressures.

Under normal circumstances, such a weak growth backdrop would argue for lower interest rates. Equally, elevated inflation and rising energy prices would typically strengthen the case for tighter policy. The Bank of England is therefore caught between two competing objectives.

For that reason, we expect the Bank to leave rates unchanged next week while retaining a cautious tightening bias. Policymakers will be reluctant to tighten policy unnecessarily into an already weak economy, but equally unwilling to risk a further deterioration in inflation expectations.

The result is likely to be a continuation of the cautious, wait-and-see approach that has characterised policy over recent months. Of all the major central banks meeting next week, the Bank of England may have the narrowest path to navigate.

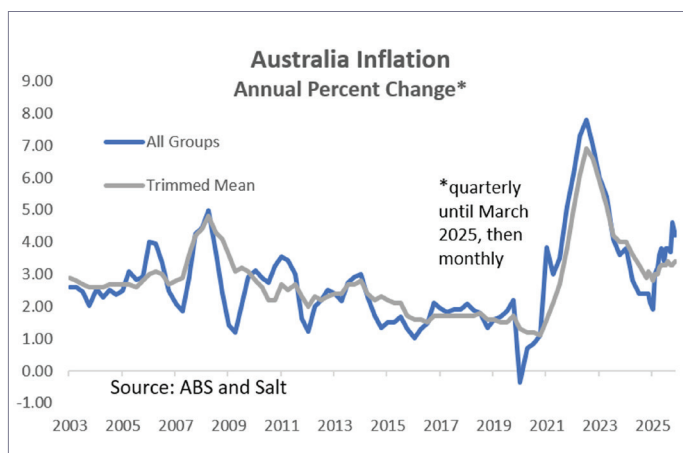
RBA: with rate hikes in the can, time to pause

The Reserve Bank of Australia is expected to leave rates unchanged next week following the rate hikes delivered earlier this year.

Unlike many of its global peers, the RBA has already responded to the resurgence in inflation pressures. Stronger-than-expected inflation outcomes, a resilient labour market and evidence that domestic price pressures were proving more persistent than anticipated prompted the Bank to tighten policy while many other central banks remained on hold.

As a result, this week's meeting is likely to be characterised by patience rather than urgency. The Australian economy is slowing but remains in better shape than many other developed economies. Labour market conditions remain

relatively tight, population growth continues to support demand and inflation remains above the RBA's target range. At the same time, policymakers will be conscious that monetary policy operates with a lag and that the full impact of recent rate increases has yet to be felt.



The recent rise in oil prices further complicates the outlook. Higher fuel costs will add to near-term inflation pressures and reinforce the RBA's concerns about the pace at which inflation returns to target. However, with policy already tightened and uncertainty surrounding the Iran conflict remaining high, there is little incentive to move again immediately.

The most likely outcome is an unchanged cash rate accompanied by a statement that retains a tightening bias. The RBA will want to keep the option of further rate increases on the table should inflation prove more persistent than expected, while allowing time to assess the impact of the tightening already delivered.

In many respects, Australia sits somewhere between the United States and Europe. Like the US, domestic demand and labour market conditions remain reasonably resilient. Like Europe, higher energy prices pose a renewed inflation risk. That combination suggests the RBA's next move remains more likely to be up than down, even if policymakers choose to pause this week.

The bigger picture

At first blush, the latest rise in oil prices might appear to have dramatically altered the monetary policy outlook. In reality, most central banks are likely to respond cautiously.

The inflation shock has undoubtedly reduced the prospect of near-term rate cuts and, in some cases, reopened discussion about further tightening. But policymakers also recognise that this supply shock is occurring at a time when many economies are already experiencing subdued growth.

Much will depend on developments in Iran and, in particular, the future path of oil prices. For now, most central banks appear willing to look through the initial rise in energy costs, viewing it as a temporary supply-side shock rather than the beginning of a new inflation cycle.

However, the longer the conflict persists and the longer oil prices remain elevated, the greater the risk that higher fuel and energy costs become embedded more broadly across the economy. History suggests central banks are generally prepared to tolerate a temporary rise in headline inflation. They become far less comfortable when higher energy prices begin influencing inflation expectations, wage negotiations and business pricing decisions.

That is ultimately the issue central banks will be watching most closely over the second half of the year. The longer the conflict lasts and the longer oil prices remain elevated, the more likely policymakers will conclude that they need to lean against the resulting inflation pressures.

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